Letter of intent

by János Veres, Minister of Finance and András Simor, Governor of the MNB

to

Mr. Dominique Strauss-Kahn

Managing Director

International Monetary Fund

Washington, DC 20431

Dear Mr. Strauss-Kahn:

1. Financial market stress in Hungary has intensified in past weeks as a result of events in global financial markets. In response, the government and the central bank of Hungary (Magyar Nemzeti Bank, MNB) have developed a comprehensive strategy to firmly anchor macroeconomic policies and reduce financial market stress. We request that the Fund supportour program through a Stand-By Arrangement (SBA) for a period of 17 months in theamount of SDR10.5 billion (€12.5 billion). This arrangement, in conjunction with support of€6.5 billion under the EU's balance of payment financing facility and other multilateral andbilateral commitments, will signal the international community's support for our policies.

2. We have discussed with IMF staff our economic program, which is outlined below. Our main objectives are to (i) reduce the government's financing needs and improve longtermfiscal sustainability, (ii) maintain adequate capitalization of the domestic banks andliquidity in domestic financial markets, and (iii) underpin confidence and secure adequateexternal financing. The government is in the process of considering additional steps toimprove the competitive position of the economy, which are fully consistent with theprogram.

3. The program will be monitored through quantitative performance criteria andindicative targets, structural performance criteria and structural benchmarks, and regularreviews. Table 1 below sets out specific quarterly targets that are to be observed under theSBA for the cash central government primary balance, CPI inflation, as well as an indicativeceiling on the overall stock of central government debt. We have already submitted to parliament an amended fiscal responsibility law before consideration of our program by theIMF's Executive Board. A support package for domestic banks will be submitted toparliament before November 10, 2008. We will also present to parliament a law to strengthenthe emergency powers of the Hungarian Financial Supervision Authority (HFSA) and pass the fiscal responsibility law by end-2008. The first review of the program will take place by February 15, 2009 and the second review by May 15, 2009. We believe that the policies set forth in this letter are adequate to achieve the objectives of our economic program, but the Government stands ready to take additional measures as appropriate to ensure the achievement of its objectives.Recent economic performance and macroeconomic framework for 2008–09

4. Macroeconomic policies have shown important results in recent years. The fiscal consolidation that began two years ago has narrowed the general government deficit from 9¼ percent of GDP in 2006 to a projected 3.4 percent of GDP in 2008 (ESA95 classification). For 2008, the projected outcome is markedly better than planned in the budget. Reflecting fiscal consolidation, the current account deficit has narrowed to a projected 6¼ percent of GDP in 2008. Monetary policy has been focused on achieving the 3 percent inflation target at the two years horizon, and the removal of the exchange rate band earlier this year has removed a potential conflict between monetary policy objectives. Inflation has fallen from 9 percent in early 2007 (when it was temporarily boosted by increases in indirect taxes associated with the fiscal consolidation) to 5¾ percent in September 2008 despite significant commodity price shocks, and is projected to fall further in 2009, although the recent depreciation of the forint may slow the decline. GDP growth is expected to recover to just under 2

percent on an annual basis in 2008, following a temporary slowdown associated with the introduction of our fiscal adjustment program in 2006.

5. In recent weeks, financial stress has increased sharply, mainly due to external factors. Investors' extreme risk aversion, which spilled over from difficulties in global financial markets, has negatively affected the foreign exchange, government securities, and equity markets in Hungary. The effect in Hungary may have been more pronounced than elsewhere in the region because underlying stock vulnerabilities (public and external debt) are still high, and financial markets are developed and deeply integrated with EU markets.

6. The outlook for 2009 is exceptionally uncertain, as it depends on global events and, crucially, on the extent to which investor confidence in Hungary can be maintained. In our baseline scenario, global financial market stress will gradually abate, which over time will reduce pressures in financial markets in Hungary. However, the global deleveraging that is already under way will reduce net capital inflows, which in turn will sharply slow credit growth in Hungary. The acceleration of our fiscal consolidation strategy will also dampen domestic demand. Export growth will be restrained by the economic slowdown among our main trading partners. As a result, output will likely fall by around 1 percent, CPI inflation 3 will decline to about 4 percent at year-end, and the current account deficit will narrow to some 2 percent of GDP. The risks to the baseline scenario are mostly on the downside, reflecting uncertainty about the speed with which financial markets will stabilize and the depth of the global economic slowdown.

7. Gross external financing needs will decline over the course of 2009, due to the smaller fiscal and current account deficits, and will be partly covered by EU structural funds (a stable source of inflows) and already committed foreign direct investment inflows. We cautiously assume net outflows from the non-financial private sector and a reduction in the government's net issuance of external debt. Foreign banks, however, are expected to largely maintain their exposure in Hungary (see below). At the same time, we aim to gradually increase the MNB's foreign reserves as a precaution against unexpected outflows. The resulting external financing need of some €20 billion can be covered by drawing on resources from the IMF, support under the EU's balance of payment facility and other official creditors. Any additional support from other international financial institutions will be used to further augment our foreign reserves.

8. Fiscal consolidation in recent years has been the cornerstone of the government's efforts to reduce macroeconomic vulnerabilities. As a share of GDP, primary government expenditures in 2008 will be reduced to below the level envisaged in the budget. This will be achieved mainly by not using contingency reserves. As a result, the general government deficit is projected to fall to 3.4 percent of GDP (or 2.9 percent of GDP, adjusted for the EU's Excessive Deficit Procedure purposes).

9. The 2009 budget will be amended to reflect the deterioration in the economic outlook and to further reduce the government's borrowing requirement. The revised budget envisages a general government deficit of 2½ percent of GDP, which implies a structural fiscal adjustment of about 2½ percent of GDP. Revenues, which are difficult to project precisely in the present environment, are expected to decline somewhat as a percentage of GDP, reflecting the slower growth of the tax base and the effect of the spending measures outlined below. The tax cuts previously envisaged for 2009 will be cancelled and we will not make any changes in the tax code that could lead to lower net revenues.

10. The necessary adjustment will focus on the expenditure side, which seems consistent with the need to reduce Hungary's comparatively large public sector as a share of GDP. Specifically, primary government expenditure (which excludes interest payments) will be reduced by 2 percentage points of GDP compared to 2008. This will be achieved by (i) keeping nominal wages in the public sector constant throughout 2009, (ii) eliminating the 13th monthly salary for all public servants, (iii) capping the 13th monthly pension payment for pensioners at HUF 80,000 and eliminating the 13th monthly pension payment for all early retirees, (iv) postponing the indexation of selected social benefits, and (v) trimming operating 4 expenditure allocations to all ministries across the board. Within the government's expenditure envelope, we will give priority to investment projects cofinanced by EU funds and programs designed to support small and medium-sized enterprises. In case of need, the government will take corrective measures to prevent the accumulation of spending arrears. The program will be primarily monitored through the primary cash balance of the central government including social security and other extrabudgetary funds (a quarterly performance criterion). We will consult IMF staff on

adjustments to the primary balance target and on eventual corrective measures in the event of a larger-than-expected shortfall in government financing, the level of public debt exceeding its indicative target path by more than 300 billion HUF, or a further significant deterioration of the macroeconomic outlook. We will also follow closely developments in local government finances and will consult IMF staff on possible corrective measures in case the aggregate deficit of local governments exceeds expectations.

11. The government is committed to maintaining fiscal discipline in the long-term, recognizing that this is a key element in retaining investor confidence. We therefore intend to continue budget consolidation in the 2010 budget—to be discussed with IMF staff as part of the program—and beyond; new medium-term fiscal targets will be contained in the forthcoming convergence program and our medium-term fiscal framework. To put fiscal sustainability on a permanent footing, we have already submitted to parliament a draft fiscal responsibility law, which establishes fiscal rules on public debt and primary deficit, strengthens the medium-term expenditure framework (rolling three-year expenditure ceilings) and creates a fiscal council to provide independent and expert scrutiny. We plan to enact this law by end-December 2008 (a structural benchmark).

12. The Hungarian banking system complies with regulatory capital requirements and has been profitable. Liquidity risk has recently increased due to the drop in global risk appetite which has increased banks' funding costs and shortened maturities. However, most of the external funding comes from parent banks in the euro area, which now have access to liquidity through ECB facilities and which have pledged their continuous support of their subsidiaries in Hungary, as reaffirmed in the joint statement of MNB and leading banks in Hungary of October 17, 2008. The MNB and the HFSA will monitor this commitment closely, and provide summary information on a daily basis to IMF staff. Domestic funding has not shown any signs of stress and any stress would be contained by the liquidity facilities mentioned below. In addition, the government has not only increased the level of deposit insurance coverage of retail deposits from HUF 6 million to HUF 13 million (in line with EU agreements) but also pledged to provide a blanket guarantee on all deposits. The government stands ready to take further measures to ensure the stability of bank funding, if needed.

13. The government is seeking an agreement with commercial banks to mitigate the balance sheet risks of households from their exposure to foreign currency loans, and to put in 5 place a private debt resolution strategy. The proposed agreement would consist of three components: (i) at the request of the debtor, the banks will allow the duration of the loan to be extended with fixed monthly installments; (ii) debtors who deem that exchange rate fluctuations carry excessive risks will be allowed to convert their foreign currency-based loan to a forint loan, without extra charges; and (iii) in the event that a debtor is unable to service the existing loan, the banks will be amenable to transitionally reducing the installments at the request of the debtor. If these strategies prove to be ineffective, additional resolution mechanisms will be considered.

14. The continuity of access to banking functions needs to be preserved at all times. In this context, we will step up our efforts to strengthen the HFSA's and MNB's capacity to assess and address solvency and liquidity concerns in banks in a timely manner. A mechanism for early remedial actions, including well-defined triggers and emergency powers for the HFSA, will be submitted to parliament by end-December 2008 (structural benchmark). We will also improve the efficiency of the bank resolution regime to facilitate paying out quickly to depositors in case of need.

15. We have developed, in consultation with IMF staff, a comprehensive package of support measures available to all qualified domestic banks, to buttress their credibility and confirm our commitment to preserving their key role in the Hungarian economy. The domestic banks have entered this period of market stress with strong solvency positions, which they have been able to preserve so far in spite of the severity of the turmoil. We are nevertheless in the process of providing a support package in line with best practices, ensuring a level playing field within the EU. The banking sector package contains provisions for added capital and funds a guarantee fund for interbank lending. Funding will be divided as follows: Total funding of HUF 600 billion will be divided evenly between the Capital Base Enhancement Fund and a and the Refinancing Guarantee Fund. The Package is available to private Hungarian banks of systemic importance. The Capital Base Enhancement Fund has been sized to bring the eligible banks' capital adequacy ratio (CAR) up to 14 percent. The Guarantee Fund is meant to bring comfort to the providers of wholesale funding and secure the refinancing of the eligible banks. Its endowment of HUF 300 billion will be invested in Euro denominated government bonds of Euro area countries and managed by the MNB. Open for new transactions until end-2009, it will guarantee the rollover of

loans and wholesale debt securities with an initial maturity of more than 3 months and up to 5 years, against a fee and with appropriate safeguards. This package should also ensure that the domestic banks remain capable of playing a responsible role vis-à-vis their foreign subsidiaries. We will submit a bill to this effect to parliament by November 10 and request an extraordinary procedure to pass the bill as soon as possible (structural performance criterion). We will monitor carefully the impact of a possible deterioration of borrowers' capacity to repay their loans as the economy slows. Recent pressures on banks' funding are being addressed by their management in close coordination with the HFSA and MNB. We welcome the involvement of EBRD in further strengthening the Hungarian banking system.

16. Over the period covered by the program, financial sector regulation and supervision will be further strengthened. Measures include (i) introduction of a positive credit registry for households, (ii) modification of the Central Bank Act to allow the MNB to request individual but unidentifiable data to adequately analyze credit risk, (iii) enhanced regulation of insurance and credit brokers and their products, (iv) introduction of maximum loan-to-value ratio requirements for new mortgage loans, and (v) close monitoring of banks' foreign exchange exposures. Given the importance of Hungary as a home and host country to foreign banks, we are strengthening communication with financial authorities in home and host countries regarding risk assessments and liquidity contingency plans.

17. The exchange rate band was removed in early 2008, moving Hungary to a floating exchange rate regime. Monetary policy is now able to focus exclusively on the inflation target, with exchange rate movements factored into the setting of the policy interest rate to the extent that they affect the outlook for inflation. In addition, the elimination of the exchange rate band has largely removed the possibility of a one-way bet against the forint in a period of financial market turmoil.

18. The MNB is determined to gradually bring inflation down to the official target of 3 percent. Under the program, progress towards this goal will be monitored using a standard consultation clause (see Appendix). Monetary policy was tightened in the first half of 2008 in response to a rise in underlying inflationary pressures and again recently to fend off a potentially destabilizing swing of the exchange rate. Looking forward, the projected economic slowdown in Hungary and the rest of the world will likely put downward pressure on inflation, but a further depreciation of the exchange rate could boost inflation. Therefore, even though underlying inflationary pressures appear to be easing, interest rate policy will remain vigilant. Monetary policy does not respond to short-term fluctuations of the exchange rate unless there is evidence that it may affect the long-term inflation outlook. Our efforts to reduce inflation will be supported by the government's intention to facilitate an agreement among social partners to restrain nominal wage growth.

19. Over the past couple weeks, in response to increased stress in domestic financial markets, we have taken a number of measures to improve liquidity. The MNB has established a foreign exchange swap facility, which is supported by a repo facility with the ECB amounting to €5 bn. We have also established an auction facility to purchase government bonds from market makers of these securities, which is intended to improve liquidity in the secondary market. The MNB has also created two new facilities to inject forint liquidity into the banking system: a two-week refinancing window at a fixed price and six-month tender with no fixed price. All of these measures are intended to improve liquidity in various market segments, not to influence prices (including bond yields), which should remain fully market-determined. The MNB stands ready to further expand its toolkit as needed.

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